

FDI Contribution to Capital Flows and Investment in Capacity

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Summary

Effects of capital inflows, and particularly foreign direct investment (FDI), on domestic investment have been the subject of recent theoretical (e.g., Loungani and Razin, 2001, and Mody, Razin, and Sadka, 2002) and empirical literature (e.g., Borenzstein, de Gregorio, and Lee, 1998, and Bosworth and Collins, 1999). This paper provides new evidence from international panel data on this issue, as well as on the related issue of the effect of domestic investment and growth on FDI, portfolio and debt flows.

Capital flows, and FDI in particular, can be beneficial both to the investors and to the host country. Economists tend to favor the free flow of capital across nations because it allows capital to seek out the highest rate of return. Unrestricted capital flows may also offer several other advantages, as noted by Feldstein (2000). First, international flows of capital reduce the risk faced by owners of capital, by allowing them to diversify their lending and investment. Second, the global integration of capital markets can contribute to the spread of best practices of corporate governance, accounting rules, and legal traditions. Third, the global mobility of capital may limit the ability of governments to pursue bad policies.

This paper explores econometrically the interactions between domestic investment and various types of capital inflows. We estimate these interactions using an international panel data set. Interactions exist, especially in the FDI and loans inflows. A noteworthy finding is the significant impact of the domestic investment on FDI inflows (0.14), after controlling for other factors of these inflows. We also find that the impact of FDI inflows on domestic investment (0.68) is a bit weaker than previously suggested in the literature, which was plagued by the endogeneity and non-stationarity problems. Still, the FDI inflows are ranked at the top compared to the other type of capital inflows in terms of its impact on domestic investment.